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TREASURY FOR OASIA/INA -- DOHNER/HAARSAGER/WINSHIP
TREASURY FOR IMFP -- SOBEL/CUSHMAN
USDOC FOR ITA DAS KASOFF, MELCHER, MAC/OCEA
NSC FOR LOI, SHRIER
STATE PASS CEA FOR BLOCK
STATE PASS USTR FOR STRATFORD/WINTER/MCCARTIN/KATZ/MAIN
STATE PASS CFTC FOR OIA/GORLICK

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SUBJECT: HOUSEHOLDS LOOKING AT REAL ESTATE PURCHASES, BUT GROWTH STILL LAGS

11. (SBU) Summary: Chinese households in cities across China began to show renewed interest in residential property during the first four months of 2009, but the boost this gives to the economy is limited because developers are still running down their housing inventory. Speculators, who drove investment and purchases on the high-priced end of the market, appear to still be mostly waiting on the sidelines. Developers, too, are cautious of overbuilding in the current environment, and have used the uptick in demand to finish delayed projects and run down their inventory. As a result, fewer construction workers are needed, although so far the overall situation is not worse than previous years, say our NGO contacts. Furthermore, a prolonged downturn would begin to impact banks, which are more dependent on the sector than the data suggests. End summary.

12. (SBU) This is the first of two cables on China's real estate sector in the first four months of 2009. The cables are the result of collaboration across the China Mission, with input and clearances from Beijing, Chengdu, Guangzhou, and Shanghai. EconOffs in those posts spoke with contacts over a period of several weeks in March-May 2009. This cable focuses on real estate sector trends--especially among households--and the impact on property developers and banks. Septel will focus on the Chinese government response to troubles in the real estate sector.

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Housing purchases are up . . .
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13. (SBU) Residential real estate trading volume in the first few months of the year has largely bounced back across China, leading our contacts throughout China to be more optimistic about the real estate market. According to a senior contact in the NYSE-listed E-House real estate firm speaking in mid May, trading volume for properties in almost all major Chinese cities returned to normal levels over the course of January-April. He

added that most of the increased buying volume is occurring at the low- and medium-priced end of the market, with smaller increases on the high-priced end. (Note: E-House's proprietary data system, known as China Real Estate Information Circle or CRIC, covers 40 cities, including most provincial capitals. End note.) The general manager at a US-Chinese manufacturing joint venture in the Chengdu Consular District noted an uptick in the housing market following the Lunar New Year in late January, with people who were waiting for prices to bottom out now feeling it is time to buy. In Guangzhou, property developer Evergrande--one of the top ten real estate firms in China--said that their sales in the first quarter of 2009 have been better than during the same period last year, and shared the view of other property developer contacts in the region who anticipated that the upward trend would continue this year.

14. (SBU) Real estate professionals and government officials alike point to the strong demand that will continue to drive the housing market, including:

- In Beijing, demand from recent university graduates moving to Beijing or parents seeking to put their children in Beijing schools, according to a contact from Regal Lloyds Real Estate.
- In Chengdu, demand from low- and medium-income buyers, about evenly split between people from Chengdu and immigrants--80 percent of whom come from elsewhere in Sichuan, according to the Chengdu Housing Management Administration (CHMA). CHMA further notes that the uptick is a natural correction from 2008, when short-term downward pressures included correcting overheated demand in 2007 as well as the impact of the earthquake and the global financial crisis on consumer demand.
- In Shanghai, demand from households relocated from rundown districts, newlyweds, and immigrants, according to an official

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with the Shanghai Municipal Urban-Rural Construction and Transportation Committee. Also, people are seeking a hedge against inflation, said a top Citibank official.

15. (SBU) Our contacts varied on the prospects of the retail and commercial property markets, however. One contact whose company operates China-wide told Guangzhou EconOff that commercial transactions were largely unaffected by the downturn, while another who focuses on South China said that both residential and commercial were affected equally, only that residential showed the effects more quickly. Beijing EconOff's contact at Regal Lloyds confirmed that the city has a large supply of empty office space--although not on Financial Street or in the Zhongguancun high-tech zone. A CBRE Shanghai contact in March said that commercial office space was likely to remain at a 30 percent vacancy rate through 2013, given the overbuild in the Lujiazui financial district, and that retail space would have a 5 percent to 10 percent vacancy rate through 2011. In Chongqing, commercial real estate turnover was lagging far behind that of booming residential turnover in February and March.

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. . . but some question the numbers
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16. (SBU) Some of our contacts see evidence of real estate developers using fake mortgages and fake pre-sales to "make up" the recovery. A Chinese Academy of Social Sciences scholar told EmbOffs that housing pre-sales--which could be manipulated by sellers to suggest heightened buyer interest--were on the rise in Beijing at the beginning of 2009. Fake mortgages are another problem, in which developers arrange for family and friends to snap up units in a new building, and will then take them back at a later date. The scholar heard a rumor that in Shenzhen there was a case involving fake mortgages for 400 apartments, and said he has heard similar stories about the housing market in Beijing. An industry expert from the Beijing-based Soufun Holdings also speculated that sellers are falsifying sales to create a "buying environment" to help with market recovery. However, he did not think it was an endemic problem, and speculated that just a few people are doing this in Beijing. In

Guangzhou, a major real estate investor told EconOff that the slight increase in prices was due more to manipulation by the real estate companies than an actual recovery.

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Speculators cautious for now . . .
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¶7. (SBU) Our contacts generally paint a picture of reduced interest from domestic and foreign real estate speculators. For instance, says a Guangdong real estate consultant, large foreign companies have been increasingly cautious about investing in South China, especially when compared with 2007. In Chengdu, there are some international buyers--e.g., from Hong Kong, the Philippines, and Taiwan--but overall domestic and foreign investors currently account for less than 10 percent of the demand, the proportion that existed before the spike to nearly 25 percent in 2007, according to CHMA. On the other hand, there are some indications of renewed interest in some areas. Since March, some Hong Kong investors have been on the lookout for cheap properties in Chongqing, according to an investment manager at a large local real estate agency. And in South China, small- and medium-size enterprises have been more active in seeking out distressed properties, according to a consultant contact there.

¶8. (SBU) Trends in the sources of funds for real estate support

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this picture, according to data from the first five months of 2009 compiled by Standard Chartered Bank and CEIC. Overall real estate investment increased 16 percent compared with the same period in 2008. Of this, deposits and advance payments were up 17 percent--indicating increased buyer interest, especially given that the same indicator fell by 13 percent in 2008-- bank loans were up 16 percent, and self-raised capital was up 11 percent. But foreign investment--an indicator of speculator interest--was down 9 percent.

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. . . and developers are running down inventory
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¶9. (SBU) Nationally, according to E-House data, builders are reluctant to start new construction projects, and instead are focusing on selling off properties already under construction. The contact cites the National Bureau of Statistics' Developers Real Estate Sentiment--which hit a low of 94.74 in March and stayed at 94.76 in April--to indicate that developers may see the bottom of the market, but are not yet in an expansionary mood. (Note: The index in May again rebounded slightly, reaching 95.94. A level of 100 in the index indicates positive market sentiment. End note.)

¶10. (SBU) In Beijing, for example, investment in residential, office, and commercial real estate has hit all-time lows, with the sharpest decline in residential real estate, which fell from a high of 36.6 percent year over year growth in June 2008 to almost no growth in February 2009. The situation is similar in Chengdu, where new housing construction was down in the first quarter by 58 percent compared to same period last year, according to the Sichuan Statistics Bureau. While overall fixed asset investment in Chengdu was up 29.5 percent in 2008 over the previous year, investment in real estate was up only 7.8 percent. As a result, real estate investment as a proportion of fixed-asset investment in Chengdu has gone down by 3.8 percentage points. (Comment: The sharply slowing growth of real estate investment in the first quarter is a drag on the Central Government's efforts to reach 8 percent growth in 2009, despite the signs of consumer interest in purchasing homes. End comment.)

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Slowdown hits construction workers
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¶11. (SBU) According to two Beijing-based migrant worker NGOs, construction workers, along with workers in export-oriented factories, are the two groups most affected by the late 2008 downturn in the job market. In addition, the NGOs tell EconOffs that wage arrears problems are up again, after declining steadily for a few years. Despite this, experts say there were fewer complaints from migrant workers in the construction industry over the wage payment issue in 2008, and thanks to the Olympic Games, the government has been paying close attention to the wage problems for migrant workers since last year. (Comment: This is mostly due to fear of collective unrest by the workers. End comment.) With so many projects currently suspended, there are still many migrants who were not fully paid, and some not paid at all, in late 2008. In sum, project suspensions have forced many construction migrant workers to stop working, and most of them had to return home earlier than ever, with only a portion of the promised annual wage, and, for some, only a small stipend. (Note: Despite this bleak picture, both NGOs say that the overall situation has not worsened from past years. End note.)

¶12. (SBU) That said, some factors may be limiting the impact on

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workers. In Sichuan, quake reconstruction is creating strong employment demand. Even some places outside the immediate quake zone seem to be reviving: a contact in Chongqing observed that, while construction activity was visibly way down in late 2008, as of January it looked like someone flipped a switch back to the previous frenetic pace, putting many people back to work. And according to a real estate industry contact in Guangzhou, all real estate companies in the region slowed their production down dramatically, especially the production of high-end housing, but due to low labor costs very few people were laid off as a result.

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Housing prices edging up in some markets
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¶13. (SBU) With trading volume for housing returning to normal levels, according to our E-House contact, prices in some markets by April had begun to rise slightly. Of the 40 cities covered by E-House, the contact pointed to Shenzhen, Hangzhou, and Chongqing as clearly coming off their lows. For example, a real estate agent contact told Chengdu EconOff his personal view on Chongqing housing was that now is the time to buy, given his sense that price and turnover signals indicate an upward trend. (Comment: This is relatively good news for the real estate industry, which has been quick to hype the shift in hope that consumers, sensing a bottom to the market, will swarm back in. End comment.)

¶14. (SBU) The potential turnaround in prices comes at the end of a long nationwide decline: sales prices in Beijing for residential, office, and commercial real estate have all seen consistent, gradual declines since 2008, and a Guangdong-based real estate investor noted that prices have fallen to 50 percent of their peak levels. Markets such as Chengdu and Chongqing avoided the extremes of the bubble, though, with a real estate investment manager there saying prices never got out of control. He noted that long-term oversupply, combined with an unwillingness of lower-end sellers to price below cost, has left prices relatively stable.

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Real estate sector still could be facing weak growth
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¶15. (SBU) Industry experts disagree on the short-term prospects for the housing market. Our Shanghai-based E-House contact predicts that trading volume will tick back down in the middle of the year--May trading slowed down from April's--before rising later in the year when medium-term consumer demand kicks in again. The contact further cites sentiment in the banking industry that loose monetary policies will be halted in the

second half, impacting mortgage lending. A leading Shanghai-based academic in mid May told a real estate conference, "It is too early to say that the real estate market will revive." Even more pessimistically, Consulate Guangzhou's real estate consultant contact strongly doubts that the market in South China will recover as long as the world economy continues to have problems, and another locally based real estate executive estimates that the China real estate market will likely not fully recover until at least 2015. By way of contrast, a Guangzhou-based executive with Evergrande--which is seeking to issue an IPO--sees a continuous upward trend this year.

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Banks relying too heavily on real estate growth?
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¶16. (SBU) Several of our contacts raised the possibility that banks are underestimating risk in the real estate sector, especially with respect to their loans to property developers, and may see a surge in nonperforming loans in a prolonged economic downturn. In the fourth quarter 2008 People's Bank of China (PBOC) Monetary Policy Report, PBOC stated that 18.3 percent of bank lending in 2008 went to real estate, including both household mortgages and loans to property developers. As mentioned above, bank lending as a source of financing for the real estate sector is up 16 percent in the first five months of ¶2009. A Chinese Academy of Social Sciences (CASS) contact, however, noted that banks were also exposed through other channels, including real estate investment trusts (REITs) and illegal channeling of funds from third-party enterprises. The contact said that these two sources make up a large portion of real estate firms' self-raised capital, which is up 11 percent in the first five months. Adding together these and other factors, according to the scholar, 80 percent of bank loans are real estate-related.

¶17. (SBU) The CASS scholar noted that if housing prices drop sharply, most of the legal and illegal loans will become non-performing. He warned that a subprime crisis may occur in China if prices continue to fall. CBRC did require banks to do stress tests on real estate lending in 2008, but no public information became available on the results. A construction expert at the Jones Day law firm in Beijing stated, "Non-performing loans are a ticking time-bomb." He speculated that many loans will be non-performing by the end of 2009, given current trends in lending. He told EconOffs that banks have thrown money at projects with little risk analysis, and will first try "evergreening" troubled loans rather than write them off. In Guangzhou, our real estate consultant contact said that banks would not be able to stay in business without the real estate industry. Given this reliance, said the contact, if prices had dropped a further 15 percent from their lows last year, banks likely would have begun to fail.

¶18. (SBU) Some banks are aware of this vulnerability, say our contacts. The executive of a Chengdu real estate company notes that banks there are less willing to lend to real estate companies and continue to rate them as high risk borrowers. In Chengdu, this has resulted in a sharp drop in lending. In 2007, 60.3 percent of commercial bank lending went to real estate; this dropped to 18 percent in 2008, and to 12.6 percent in the first two months in 2009. In Beijing, the Jones Day expert told EconOffs that, while banks are more willing to lend to construction projects, they are cautious about lending to private developers and real estate projects. He added that there isn't a lot of sympathy for private developers, and there is virtually no pressure from the government to lend to them. As a result, bank loans are not reaching smaller real estate and development firms, and there's a sense that there needs to be some consolidation, he said.

¶19. (SBU) At the same time, our contacts agree that banks are not at risk from homeowner defaults. Chinese industry experts

told EconOffs that mortgage defaults are not the "Chinese way," and they are sure people will continue to make home payments.

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Comment
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¶20. (SBU) Our contacts describe a real estate industry that narrowly avoided larger problems this past fall, and now is eager to find signs that the downturn has ended and profit growth can return. However, the short-term prospects are still uncertain, leaving the industry in a mood to coast along rather

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than rev up a new wave of investment and construction. This industry mood is further darkened by Central Government policy, which septel describes as running contrary to real estate developers' hopes by emphasizing low-profit affordable housing rather than the double-digit returns of luxury apartments and villas. All this points to real estate investment remaining low until developers are more certain about medium term trends, and that the boost real estate investment has given to gross capital formation--the biggest single contributor to recent years' GDP as measured on the expenditure side--will remain muted this year even as the Chinese Government tries to achieve 8 percent GDP growth.

¶21. (SBU) Aside from the GDP impact of construction activity, the prospects of higher housing demand and rising real estate valuations could provide a boost to consumer spending. Several of our contacts noted that the simultaneous hits from the stock market fall and the slump in real estate prices had taken a toll in consumer confidence. This is widely regarded as true despite high retail sales growth rates--which continue at above-GDP growth rates, and therefore are helping to pull the economy--since retail sales covers more than household purchases. A Guangzhou-based executive with a real estate developer that operates China-wide commented that Guangzhou's local measures were aimed more at increasing consumer confidence than actually helping the industry, implying that the government there is making the connection between consumer spending and the real estate market as well.

CAMP